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BEFORE THE ARIZONA CORPORATION COMMISSION

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COMMISSIONERS

JEFF HATCH-MILLER, Chairman
WILLIAM A. MUNDELL
MARC SPITZER
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KRISTIN K. MAYES

AZ CORP COMMISSION
DOCUMENT CONTROL

IN THE MATTER OF THE COMMISSION'S
GENERIC EVALUATION OF THE
REGULATORY IMPACTS FROM THE USE
OF NON-TRADITIONAL FINANCING
ARRANGEMENTS BY WATER UTILITIES
AND THEIR AFFILIATES

Docket No. W-00000C-06-0149

**CERTIFICATE OF FILING OF
RESPONSE TO STAFF'S QUESTIONS**

Arizona Water Company is today filing its attached responses to Staff's Questions in this docket as presented in a June 2, 2006 letter to Water Company Representatives from Ernest G. Johnson, Director, Utilities Division.

RESPECTFULLY SUBMITTED this 23rd day of June 2006.

ARIZONA WATER COMPANY

By:

Robert W. Geake

Robert W. Geake
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Attorneys for Arizona Water Company

AN ORIGINAL and thirteen (13) copies of the Foregoing and attachment filed this 23rd day of June 2006 with:

Docket Control
Arizona Corporation Commission
1200 W. Washington
Phoenix, AZ 85007

By: Robert W. Deake

ARIZONA WATER COMPANY

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June 23, 2006

Mr. Ernest G. Johnson
Director, Utilities Division
Arizona Corporation Commission
1200 West Washington Street
Phoenix, AZ 85007-2927

Re: Generic Evaluation on the Use of Non-Traditional Financing Arrangements by
Water Utilities and Their Affiliates; Docket No. W-00000C-06-0149

Dear Director Johnson:

Pursuant to Utilities Division Director Ernest G. Johnson's letter inquiry dated June 2, 2006 in this docket, Arizona Water Company hereby submits its comments to the questions in that letter. Arizona Water Company specifically notes that some of the same issues are being addressed in a formal complaint proceeding that Arizona Water Company has brought against Global Water Resources LLC and other Global Entities in Docket Nos. W-01445A-06-0200, SW-20445A-06-0200, W-20446A-06-0200, W-03576A-06-0200 and SW-03575A-06-0200 (the "Global Complaint Proceedings"). A procedural conference was just held on June 15, 2006 before Administrative Law Judge Dwight D. Nodes in the Global Complaint Proceedings, and further rulings are anticipated shortly as to the status of those proceedings. Accordingly, Arizona Water Company submits these comments as called for by Director Johnson without prejudice to its procedural rights to proceed with discovery and the taking of testimony in the Global Complaint Proceedings that may relate to some of the same issues.

In addition to the impact of the Global Complaint Proceedings on Director Johnson's June 2 request letter, Commissioners Mundell and Hatch-Miller have filed letters in this docket further defining how the matter is to proceed (see Commissioner Mundell's letters and attachments dated June 7 and June 13, 2006 and Chairman Hatch-Miller's letter dated June 12, 2006). Although the procedures the Commission intends to follow have not been definitively set, Commissioner Mundell's June 7, 2006 letter suggests that the Global Water Resources entities will make a presentation to the Commission on issues of interest in this docket, including specific questions raised by Commissioner Mundell in his letters, with presentations by other private water companies to follow. Arizona Water Company specifically reserves its rights to participate fully in these proceedings, and by filing these comments to Director Johnson's letter, does not intend to have these comments serve as a full statement of its position regarding allegations about the business activities of the Global Entities, as set forth in the Company's formal complaint in the Global Complaint Proceedings. Again, it appears that an opportunity to

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do so will be presented later by way of response to any presentations made by the Global Entities, as the Commission may direct.

Under these conditions, Arizona Water Company responds to the June 2 letter inquiries as follows:

1. What is the preferred regulatory treatment for each of the following financing arrangements?

A. A developer purchases a non-regulated parent company's non-voting stock. Each of the non-voting shares has a par value of \$1.00, is not eligible for dividends, is partially refundable and can be repurchased (subject to certain conditions) by the non-regulated parent for one cent (\$0.01). See attached diagram at Exhibit A. The parent company subsequently contributes the funds to an ACC regulated subsidiary water utility as additional paid-in capital.

Proposed Regulatory Treatment:

The zero cost capital provided to the regulated subsidiary water utility by the developer, through the non-regulated parent, should be recognized as a Contribution in Aid of Construction ("CIAC") and recorded as such on the regulated utility's books and should be deducted from rate base in ratemaking.

Rationale:

It is not clear what the developer's interest in such a scheme would be. Because the stock "purchase" by the developer is a sham transaction, the typical rights of stock ownership are completely absent, and the developer is not legitimately purchasing the non-regulated parent's non-voting common stock as an investment. Rather, the developer's motivation in purchasing the stock appears solely to obtain water utility services under more favorable financial terms than if the developer entered into a main extension agreement subject to the oversight of the Commission directly with the regulated water utility, as the Commission's rules and regulations expressly provide.

The regulated utility's rates should not be based on an inflated rate base. It would be improper to include depreciation expense on the utility plant constructed with contributed funds treated as paid-in equity capital, or allow a return on the utility plant by including it in rate base. Otherwise the utility's customers would be paying twice for the utility plant: once for the cost of the stock purchase by the developer in their home price and a second time through their water rates. In addition, all of the utility's customers bear the risk if the development is unsuccessful.

B. A developer purchases a regulated utility's non-voting stock and that utility invests those funds in plant. The utility records equity for the proceeds. Neither refundable advances in aid of construction nor contribution in aid of construction are recorded.

Proposed Regulatory Treatment:

The main extension rule, R14-2-406, should be enforced in this scenario, in the following way:

1. Require that service to new developments be installed only after the developer enters into a main extension agreement with the regulated utility for all of the necessary off-site and on-site infrastructure necessary to serve the development;
2. Require the developer to advance or contribute the necessary funds as specified in the main extension agreement with the regulated utility; and
3. Require the regulated utility to obtain the Commission's approval of the main extension agreement with the developer. The funds provided to the utility by the developer under the main extension agreement would be accounted for as an advance in aid of construction ("AIAC") or CIAC and deducted in determining the utility's rate base.

Rationale:

The main extension rule exists to shield regulated utilities and their customers from the risk of development. Under this questionable alternate financing scheme the customers again would be paying twice for the utility plant and all of the utility customers would bear the risk of an unsuccessful development.

C. A developer or a Municipal Government pays a fee for services provided by a non-regulated parent company for services typically covered by "off-site Hook-up Fees" collected by regulated water and wastewater utilities. Then the parent company invests the proceeds in the regulated utility which is recorded as equity by the utility.

Proposed Regulatory Treatment:

The Commission should regulate the charges for utility type services and require that the fees collected be accounted for as either an AIAC, if refundable, or CIAC, if non-refundable.

Rationale:

The regulated water utility has an obligation to provide necessary water utility services and extensions of such service within its certificated area in accordance with the main extension rule, and to account properly for funds it receives (whether directly or indirectly) from developers and municipalities. In order to protect the public, the Commission regulates both the amount of the fees that may be collected and the accounting and ratemaking treatment of those fees. In the ratemaking process, the Commission treats such "off-site Hook-up Fees" the same as any developer advances or contributions – they are excluded from rate base, and customers' rates do not include a rate of return on those amounts. A contrived corporate structure with equity derived from Hook-up Fees should not be allowed by the Commission to disguise the true nature

of an entity's sources of capital so as to allow it to record as equity, and require customers to pay a return on, funds the Commission traditionally excludes from rate base. This again places the risk of an unsuccessful development on the utility's customers and results in double payments by the customers. Proper accounting and the use of AIAC and CIAC are necessary to protect the customers and the utility.

2. What is the maximum percentage of refundable "Advances in Aid of Construction" ("AIAC") appropriate as percentage of total capital for a private or investor owned water utility?

Response:

There is no normative maximum water utility percentage that can be used to evaluate the proper level of AIAC and CIAC as a percentage of a water utility's total capital. The total average AIAC and CIAC as a percentage of capitalization by company class abstracted from the 2004 National Association of Water Companies Financial Summary shows that the percentage varies from 19.6% for the Class A-1 companies to 137.3% for the Class A-4 companies (Exhibit 1). Applying a one-size-fits-all rule would not be appropriate; rather, Staff should perform a more detailed financial evaluation in each case to assess the impact of each new main extension agreement on the utility's financial viability.

3. What is the maximum percentage of non-refundable "Contributions In Aid of Construction" ("CIAC") appropriate as a percent of total capital for a private or investor owned water utility?

Response:

See response to Question 2 and Exhibit 1.

4. What is the most appropriate and most economical capital structure for a "new" water or wastewater utility?

Response:

The initial capitalization should include both equity and debt. Referring to Exhibit 1 (shown below), common equity of at least 50% for a "new" water or wastewater utility would place it within the NAWC parameters for existing water utilities. However, there is no reason for the Commission to approve certification of a new water or wastewater utility that is not adequately financed in accordance with Commission rules and the uniform system of accounts and which needs to resort to unconventional and questionable financing schemes. There are numerous existing, well capitalized utilities in Arizona, such as Arizona Water Company, that are available and willing to serve developments within the State in accordance with the Commission's longstanding procedures for having developers provide AIAC and CIAC so as to minimize the customers' rates.

Exhibit 1**Average CIAC and AIAC Per Company Within Gross Revenue Class**

	<u>CE</u>	<u>LT Debt</u>	<u>Total</u>	<u>CIAC</u>	<u>AIAC</u>	<u>Total CIAC & AIAC</u>
A-1 (Gross Revenues: \$10,000,000 & over)						
\$	146,092,895	155,665,476	301,758,371	35,353,894	23,906,269	59,260,163
%	48.4%	51.6%	100.0%	11.7%	7.9%	19.6%
A-2 (Gross Revenues: \$5,000,000 & over)						
\$	12,549,920	9,256,726	21,806,646	7,438,235	2,989,001	10,427,236
%	57.6%	42.4%	100.0%	34.1%	13.7%	47.8%
A-3 (Gross Revenues: \$1,000,000 & over)						
\$	6,442,979	4,414,904	10,857,883	7,799,123	881,691	8,680,814
%	59.3%	40.7%	100.0%	71.8%	8.1%	79.9%
A-4 (Gross Revenues: less than \$1,000,000)						
\$	829,149	742,994	1,572,143	530,822	1,627,133	2,157,955
%	52.7%	47.3%	100.0%	33.8%	103.5%	137.3%

Source: 2004 National Association of Water Companies Financial Summary

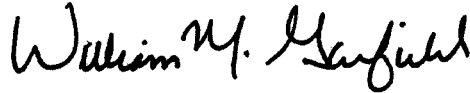
ARIZONA WATER COMPANY

Mr. Ernest G. Johnson
Arizona Corporation Commission

June 23, 2006
Page 6

Thank you for the opportunity to provide comments. Arizona Water Company looks forward to further participation in these proceedings and opportunities to provide additional comments on this matter.

Very truly yours.



William M. Garfield
President

jrc

c: Division Managers
Route - Phoenix Staff
bc: R.H. Nicholson, Jr.